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IN THIS ISSUE:

Japan's Economy Slows In Third Quarter 1

Ups And Downs In Cabinet Support 3

Defense Spending Hike Negotiations 5

Japanese Institutions Primed For Primary Dealership 6

Joint Economic Committee Hosts Pacific Rim Conference 7

New Members Named To House Ways And Means Committee 8

Washington Reviewing Japan's Supercomputer Trade Practices 10

White House Fills In Blanks In Machine Tool Plan 11

Notes: Tax Reform; Kansai Airport; Japan-EC Talks 14

Japan's Economy Slows In Third Quarter

A decline in net exports slowed inflation-adjusted growth in Japan's gross national product to a 2.6 percent annual rate in the July-September quarter, down from a revised 3.8 percent in the April-June period. The sluggish growth rate makes it unlikely that the economy will reach the government's outlook of 4 percent real growth in FY 1986 (April 1, 1986 to March 31, 1987).

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	October-December 1985	January-March 1986	April-June 1986	July-September 1986
Gross National Product	Y293,332.7 (4.3%)	Y295,760.3 (4.7%)	Y294,483.4 (-1.7%)	Y297,230.1 (3.8%)	Y299,128.5 (2.6%)
Personal Consumption Spending	162,999.0 (2.6%)	163,477.4 (2.1%)	164,123.7 (1.6%)	166,134.2 (5.0%)	168,252.2 (5.2%)
Private Residential Construction	14,107.9 (2.9%)	14,124.4 (6.8%)	14,340.6 (6.3%)	14,808.5 (13.7%)	15,857.2 (31.5%)
Private Fixed Nonresidential Investment	53,760.3 (12.9%)	54,811.3 (10.8%)	54,983.4 (1.3%)	55,204.3 (1.6%)	55,469.9 (1.9%)
Change in Business Inventories	2,016.2 (8.7%)	2,172.1 (77.0%)	1,726.5 (-60.0%)	639.5 (-98.1%)	809.4 (156.6%)
Government Current Expenditures	27,240.9 (1.9%)	27,370.1 (3.9%)	27,606.7 (3.5%)	27,719.2 (1.6%)	28,015.3 (4.3%)
Government Fixed Investment	20,772.5 (-6.4%)	20,960.5 (7.1%)	21,022.4 (1.2%)	21,785.4 (15.3%)	22,144.6 (6.8%)
Change in Government Inventories	297.9 (*)	608.7 (*)	39.6 (*)	3,251.8 (*)	1,795.1 (*)
Net External Sector	12,138.1 (19.9%)	12,235.9 (-4.7%)	10,640.6 (-42.8%)	7,687.2 (-72.8%)	6,784.8 (-39.3%)
Exports of Goods and Services and Factor Income Received	54,496.6 (1.8%)	53,973.3 (-7.1%)	52,208.9 (-12.4%)	53,044.1 (6.6%)	52,497.7 (-4.1%)
Imports of Goods and Services and Factor Income Paid	42,358.6 (-2.4%)	41,737.5 (-7.8%)	41,568.3 (-1.6%)	45,356.9 (41.8%)	45,712.9 (3.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Domestic demand accounted for 0.9 percentage point of the 0.6 percent quarterly GNP gain, while the external sector lowered growth by 0.3 percentage point. Net exports have now declined for five consecutive quarters, reflecting the impact of the strong yen. Economic Planning Agency officials note that the economy is apparently shifting from exports to domestic demand.

Housing construction soared at a 31.5 percent real annual rate, the highest in 10 years (see Table), as a result of lower interest rates and a cut in taxes on housing. The front-loading of public works projects in the first half of FY 1986 resulted in a substantial rise in government capital formation. Business fixed investment, however, remained sluggish for the third consecutive quarter, reflecting the drop in earnings. Wako Research Institute of Economics estimates that the pretax profits of Japan's major firms will drop 19.9 percent in the current fiscal year.

Encouraged by the stability of prices, the inflation-adjusted rise in consumer spending was in the 5 percent range for the second straight quarter. Many economists, though, question whether it will continue to expand at this rate. While the deflationary effects of the strong yen have been concentrated in export-oriented industries, a report last week by the Bank of Japan said there are signs that it is spreading to the rest of the economy through wage and employment adjustments. One indication is smaller yearend bonuses for workers. A survey by Nikkeiren (Japan Federation of Employers' Associations) estimates that December 1986 bonuses will be 2.8 percent below last year's.

A study of wholesale and consumer prices by the Bank of Japan concluded that business firms have not passed on to consumers enough of the benefits of the yen's appreciation. Import prices in Japan plunged 43 percent between September 1985 and September 1986, compared to 21.5 percent in West Germany. But while consumer prices fell 0.9 percent in West Germany in that period, they rose 0.5 percent in Japan. A report to the Minister of Labor reached the same conclusion; a survey of more than 100 consumer items concluded that it takes Y231 (about $1.44 at Y160=$1.00) to buy the same products in Japan that $1.00 buys in the United States.

With the Bank of Japan's discount rate at a postwar low of 3 percent, efforts to boost the economy will probably rest with fiscal policy. The Ministry of Finance plans to present the draft FY 1987 budget on December 25, a draft that will take into account tax reform proposals. MOF officials indicated last week that the budget may not achieve the government's goal of reducing deficit-covering bonds by Y1.31 trillion ($8.2 billion) in the year starting April 1, 1987.

Randall S. Jones

Ups And Downs In Cabinet Support

According to a recent survey by the Asahi Shimbun, support for the cabinet of Yasuhiro Nakasone has fallen to its lowest level in three years. The December 7 edition reported a drop to 39 percent, far from the 53 percent figure of May 1986. More significantly, outright opposition to the cabinet had increased to 33 percent, well over 10 percentage points above figures compiled last spring.

Cabinet Support, December 1982-December 1986

(percentage)

Date	Favor Cabinet Policies	Disapprove	No Opinion
December 1982	37%	37%	26%
February 1983	29	43	28
May 1983	30	40	30
August 1983	35	43	22
October 1983	34	39	27
December 1983	34	41	25
March 1984	45	33	22
May 1984	44	32	25
September 1984	40	32	28
October 1984	45	30	25
December 1984	42	30	28
March 1985	45	30	25
May 1985	47	26	27
June 1985	45	25	30
October 1985	46	29	25
December 1985	43	27	30
March 1986	53	21	26
May 1986	53	22	25
August 1986	48	30	22
October 1986	42	32	26
December 1986	39	33	28

Source: Asahi Shimbun

Although the possible reasons for the decline are not entirely clear, the newspaper noted that the survey was conducted as Diet action on the government's plan to reorganize the Japanese National Railways neared conclusion and in the midst of tax reform deliberations (see note in this issue). Support for the cabinet had been consistently high from March 1984 through June 1986. It was one factor behind Mr. Nakasone's double election strategy of last July. The same survey, however, indicated approval for the Liberal Democratic Party was at a high 55 percent, unchanged from the paper's previous three surveys. (The Japan Socialist Party remained far behind in second place at 18 percent.)

Another survey by the Kyodo News Service showed cabinet support at very high levels: 54.9 percent, less than one percentage point off from its September survey. Kyodo's results were also favorable for the LDP, with public support for the party well above 50 percent and about three times that of the JSP.

Explaining these discrepancies is something of a challenge, particularly in view of the widely held perception that Mr. Nakasone is a popular figure in

Japan. The Kyodo polls consistently have registered higher support levels for the Nakasone cabinet than the Asahi surveys, although the general trends have been in harmony. One possible interpretation is that while the prime minister is widely admired, the policies of his government are generating increasing opposition from voters. Another alternative is that the "magic" of the Nakasone years has faded somewhat, leading some well-informed observers to suggest that he may indeed step down from office next June rather than see his popularity -- and therefore influence -- wane any further. In any event, the overall thrust of current government policies is unlikely to change as a result of the surveys.

Michael W. Chinworth

Defense Spending Hike Negotiations

According to recent Japanese press reports, the Ministry of Finance and the Japan Defense Agency are in the midst of intense negotiations over the size of the fiscal 1987 defense spending increase. MOF reportedly seeks a hike of no more than 4 percent while JDA is aiming for at least 7 percent. Both sides apparently are using the same circumstances to justify their positions. The outcome of the discussions could affect the defense issue significantly in Japan.

MOF hopes to limit next year's increase because certain JDA expenses -- fuel costs, for example -- are falling dramatically as a result of lower prices and the strengthened yen. JDA, however, is using the same argument to call for bigger increases. The agency says that reduced costs could enable the Self-Defense Forces to expand inflight training times, which have fallen gradually over the last decade, in part because of higher fuel prices and tight budgets.

The size of next year's increase could also precipitate still another debate over the viability of Japan's longstanding policy of limiting overall defense spending to one percent of the country's gross national product. Slower-than-expected economic growth in recent years, particularly in 1986, and significant budget increases have brought total defense spending close to the one percent limit; indeed, the ceiling may have been exceeded already. The Nakasone cabinet has vowed to honor the restriction as far as possible but has moved away from the policy in symbolic terms by referring to it as a guideline rather than a strict limit. Should slow growth continue, a 7 percent hike could bring defense spending over that level. In fact, one reason for MOF's position may be that it intends to bring defense spending back within the one percent figure.

While these negotiations continued, the Japanese delegation on the Strategic Defense Initiative completed a second round of discussions in Washington. Business leaders are concerned that Japanese companies might be unable to benefit commercially from their involvement in the program if the Department of Defense places severe restrictions on the repatriation of SDI-generated technology. The first delegation came through Washington in late October, primarily to set the stage for future talks. The Japanese government officially agreed to allow Japanese companies to participate in the SDI research program in early September, shortly after JDA director general Yuko

terms of price-performance ratios and the company has a large library of software; CDC has no units in operation in Japan. Of the six Cray supercomputers installed in Japan, just three are owned by publicly funded organizations -- the University of Nagoya, the University of Tokyo and Nippon Telegraph and Telephone Corp. (The other three Crays belong to Mitsubishi Research Institute, Toshiba Corp. and Nissan Motor Co., Ltd.) Moreover, no government-financed body has ordered a Cray since NTT's X-MP was delivered in August 1984.

Equally disturbing to Cray and CDC is the toehold Fujitsu and NEC have gained in the supercomputer market outside Japan. As of mid-1986 Fujitsu reported that it had received orders from 14 foreign customers through affiliate Amdahl Corp. and West Germany's Siemens AG. For its part NEC has won one contract from an American organization -- the Houston Area Research Center, a consortium of four Texas universities. Probably more than any other single development, this January 1986 contract award transformed supercomputers into a bilateral trade issue since HARC was reportedly planning to buy an American-made system until NEC came in with what Cray and CDC executives felt was an unfairly low bid.

While the two supercomputer manufacturers were reluctant to go public with their suspicions, corporate executives did raise the matter with members of the administration's trade "strike force," which was set up in September 1985 to identify unfair foreign trade practices that the White House could then pursue by self-initiating investigations. Starting off with the U.S. industry's specific complaint, the strike force broadened its focus to include the possibility that Japan may be targeting markets at home and abroad by protecting and promoting its supercomputer industry. The group finally recommended that President Reagan take action, but in deciding to self-initiate an investigation the White House took the least confrontational route available -- a Section 305 fact-finding inquiry.

Susan MacKnight

White House Fills In Blanks In Machine Tool Plan

On December 16 President Reagan detailed what he called a comprehensive government plan to encourage modernization of the U.S. machine tool industry. The centerpiece of the program is the restraint arrangement negotiated with Japan (see JEI Report No. 44B, December 5, 1986), which is outlined below. Another major component is the agreement worked out with Taiwan to limit its U.S.-bound exports. This pact mirrors the main provisions of the five-year accord with Tokyo. Effective January 1, 1987, Taiwan will restrict shipments of milling machines and manual lathes to their 1981 U.S. market shares and will hold exports of numerically controlled lathes and machining centers to last year's market shares.

The administration also notified West Germany and Switzerland that their shipments in certain product lines must be maintained at specified levels for the next five years after these two countries refused to negotiate voluntary restraint arrangements with Washington. In addition, the White House put other foreign suppliers on notice that their exports will be monitored to insure that they do not try to capitalize on the limits on deliveries from Japan, Taiwan,

West Germany and Switzerland. Backing up this warning, the president indicated that he was prepared to take appropriate unilateral action to restrain imports from these third-tier suppliers.

Department of Commerce analysts estimated that the various import restraint measures would boost U.S. capacity utilization in key computer-controlled machine tool product lines (lathes, machining centers and punching and shearing machines) from 41 percent to 60 percent. They projected as well that these steps would lead to $800 million in "additional revenue opportunities" for American builders during the life of the program.

In a companion move, the president also outlined a "domestic action plan" development by Commerce and the Department of Defense. The purpose of this plan, he noted, is to complement the industry's own modernization efforts by integrating the domestic industry more fully into the defense procurement process; linking industry programs with existing DOD programs to improve manufacturing technologies; and providing up to $5 million annually for the next three years in matching funds to support the private sector's National Center for Manufacturing Sciences.

Susan MacKnight

Commerce Department Fact Sheet on Arrangement with Japan

Japan has agreed to restrict exports of the following high technology machine tools to its 1981 U.S. market share levels:

Category	Agreement Level	1985 Level	Market Share Reduction
Numerically Controlled Lathes	57%	66%	9 points
Machining Centers	52%	73%	21 points
Numerically Controlled Punching and Shearing Machines	19%	43%	24 points

Japan has also agreed not to exceed its 1985 market shares for the following product categories:

Category	Agreement Level
Milling Machines	3%
Manual Lathes	5%
Manual Punching and Shearing Machines	9%

The value of all these reductions in Japanese exports is about $159 million per year, or about $795 million over the five year VRA period assuming constant demand.

Projection of U.S. apparant consumption for each arrangement product will be based on Commerce Department statistics. We have agreed to consult with the Japanese to select an independent forecaster to make such projections.

Machine tool kits will be counted against overall category limits. Further, the Japanese have agreed to work with us on subassemblies to insure that they do not exceed 1985 levels and impair the purpose of the agreement.

Japan will require export licenses for the three high technology product categories and will provide administrative guidance to manufacturers regarding the other product categories. During the remainder of 1986, no export licenses will be required for any products; however, Japan has agreed not to allow a surge in exports.

During 1987 and 1988 Japan will be able to export a limited number of additional machining centers and NC punching and shearing machines. With regard to machining centers, it will be able to export an additional 100 units in 1987 based on likely short supply problems.

During each year of the VRA, there will also be a joint set-aside of 1.5 percent of the market for machining center kit imports that lead to new investment and full machine tool production in the United States. This could give Japanese suppliers an additional 1.5 percent of the U.S. machining center market if they demonstrate that 1.5 percent of their exports lead to new machine tool production in the United States. However, they could also lose 1.5 percent of their market share if they do not qualify.

With regard to NC punching and shaearing machines, Japanese producers will be able to export an additional 60 units in 1987 and 30 in 1988 provided they are shipped to U.S. original equipment manufacturers. This is designed to help these U.S. companies phase out imports.

The impact of these additional factors would mean between 190 and 230 additional units imported from Japan during the first year of the VRA, valued between $19 and $22 million. The total impact of these factors over five years would amount to between 190 and 500 additional units, valued between $19 and $51 million.

The VRA will run for five years beginning January 1987 with a joint review after three years. (U.S. agreement would be required to amend the terms of the VRA.) During the transition period from June through December 1986, Japan will not issue licenses to exporters, but will be required to limit shipments to their 1985 share of the U.S. market.

The VRA specifies that imports must be maintained with the 1985 product mix in order to prevent shifts into higher-valued categories. It also includes other administrative provisions we consider essential to maintain the overall integrity of the VRAs.

As part of this VRA, we have agreed that the United States will not impose unilateral trade controls under Section 232 of the 1962 Trade Expansion Act provided that the VRA is implemented and enforced effectively. Further, we have agreed to monitor imports from other countries and insure that these countries do not capture Japan's market share.